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# **AICPA** *Washington Report*

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FEDERAL DEPOSIT INSURANCE CORPORATION

"...I recently suggested that it would be to the benefit of all if the independent auditors were under an obligation to notify the supervisory authorities when they uncovered a major fraud or evidence of abuse," FDIC Chairman L. William Seidman told the West Michigan Accounting and Auditing Symposium. He said he made this suggestion "in the interest of pursuing dialogue." He noted, "This may represent a change in the traditional lines of responsibility of the auditor and examiner, but it is a change we should continue to at least consider." Mr. Seidman's comments were made during a 6/19/86 address entitled "The Role of Outside Auditors in Today's Banking Industry" in Grand Rapids, MI. He began by noting that the traditional roles of the bank auditor and examiner are "blurring." Traditionally, Mr. Seidman said, bank auditors were the "'eyes and ears' of the board of directors and the shareholders of a bank. Bank examiners, on the other hand, were looking after the interests of the depositor and the general public." Now, however, he said, "Auditors and examiners more and more have the same audience. Not only do auditors have a responsibility to the board of directors and shareholders, but many people now claim that their audited financial statements are also for use by the public, analysts, and government officials."

Mr. Seidman focused on five specific areas in his speech: 1) control systems and fraud detection, 2) loan portfolio, 3) reserve for loan losses, 4) legal considerations, and 5) communications. About the first subject, he said, "From the FDIC's standpoint, the most important role the outside auditor has in a bank is confirming the strength of its control systems--both internal controls and management controls. Although our examiners have always scrutinized this area, the increasing importance of sound control systems for the prevention of insider abuse, fraud, and embezzlement warrants greater attention." Mr. Seidman then stated; "An FDIC survey of insured banks that failed from 1980 to 1982 found fraud and embezzlement by insiders were a major factor (but not necessarily the primary factor) in 15 percent of the failures. Credit losses on loans to insiders were a major factor in 27 percent of the cases...Of course, the outside auditor can do only so much. A bank's internal audit department is its first line of defense against fraud and insider abuse. No bank is too small, in our opinion, to have an adequate system of internal controls even if it does not rise to the level of a separate 'department'...We are stressing fraud detection with our examiners, and believe it is an area in which outside auditors and bank supervisory agencies can work together to strengthen the banking system."

Regarding the loan portfolio, Mr. Seidman recommended that outside auditors "may wish to strengthen their review of asset quality." He also said that an independent review of the reserve for loan losses and the assessment process used by management could "greatly reinforce our efforts." He noted that "an understated reserve for loan losses is one of the more frequent deficiencies found by our examiners" and that "an inadequate loan loss reserve overstates earnings and capital, provides false and misleading financial information to the public, and ultimately may threaten the soundness of the bank." About his fourth topic, legal considerations, Mr. Seidman said: "...You are probably well aware that the FDIC in its role as receiver of a failed bank has and will continue to review the work of any prior outside audit to determine whether there is a cause of action against the auditor." He noted that the FDIC currently is involved in three lawsuits against independent auditors of failed banks and that "while there was some degree of fraud involved in two of these cases, none of our claims is based solely upon the failure of the audit firms to detect and report fraud. In fact, our claims are based principally upon the audit firms' failures to adequately review credit files." He also pointed out the possibility of private litigation against independent auditors. He said, "...While the law differs somewhat among

the states, courts in several major jurisdictions have held that accountants can be liable for negligence to third parties. Every independent auditor should keep that fact in mind when carrying out his duties." Mr. Seidman concluded his remarks by observing, "We at the FDIC believe that our whole financial system would be strengthened through closer cooperation between independent auditors and the FDIC."

#### NATIONAL CREDIT UNION ADMINISTRATION

Member Business Loans by Federally-Insured Credit Unions is the title of a notice of proposed rulemaking by the National Credit Union Administration (see the 6/26/86 Fed. Reg., pp. 23234-40). The proposed rule, according to the NCUA, establishes conditions under which Federally-insured credit unions may grant member business loans. The first section defines the type of loans the NCUA Board considers to be member business loans within the scope of the rule and the remainder sets out specific limitations, requirements, and prohibitions in making such loans. The rule is necessary, according to NCUA, in light of recent liquidations and other problem cases involving unsound business lending practices by the federally-insured credit unions. Comments must be received by 9/30/86. For further information contact J. Leonard Skiles at 202/482-5131.

#### SECURITIES AND EXCHANGE COMMISSION

The Securities and Exchange Commission hasn't "seen adequate evidence to demonstrate that the benefits could reasonably be expected to exceed the costs..." according to testimony by SEC Chairman John S.R. Shad concerning H.R. 4886, the "Financial Fraud Detection and Disclosure Act of 1986." In a 6/23/86 appearance before the House Energy and Commerce Oversight and Investigations Subcommittee hearing entitled "Improving Performance of Independent Auditors under Federal Securities Laws," Mr. Shad spent the preponderance of his time responding to questions about Rep. Ron Wyden's (D-OR) bill, H.R. 4886, and according to Chairman John D. Dingell (D-MI), how the SEC exercises its authority to require changes to improve the quality and effectiveness of corporate financial disclosures. Mr. Shad stated that if enacted, H.R. 4886 would "obviously dramatically" increase the costs of audits, costs that are borne by investors and consumers. "We haven't seen adequate evidence to demonstrate that the benefits could reasonably be expected to exceed the costs...." Expanding on the SEC's concern that the bill could significantly increase the costs of the audit, Mr. Shad referred to a 1979 survey of 500 companies to determine costs associated with requiring auditors to report on the internal controls. The survey, according to Mr. Shad, stated that it would cost \$267,000 in the first year and \$219,000 per annum thereafter to include reports on internal controls. Mr. Shad stated: "Now, that compares with an average cost of an audit today of \$90,000. So just to deal with that one item, the survey indicated it would be a threefold increase over what the audits now cost...." Asked to respond to a section of H.R. 4886 which requires auditors to report actual or suspected illegal activities to the SEC and other appropriate enforcement or regulatory authorities, Mr. Shad suggested that management be given a chance to respond to the auditors' findings or concerns and take corrective action. In response to another section of the bill which provides, according to Rep. Wyden, "... legal protection for the auditor who complies in good faith with the fraud detection and disclosure requirements," Mr. Shad stated, in part, that the bill provides a safe harbor for reporting by the auditor, but no similar protection for things not discovered and consequently not reported. Mr. Shad also stated that since the auditor only has risk for not reporting, the bill could result in an overflow of "soft leads."

**TREASURY, DEPARTMENT OF**

Magnetic media filing requirements is the subject of a recently released IRS Revenue Procedure, No. 86-31, and explains how to apply for approval to use a particular form of magnetic medium or to request a waiver because of undue hardship. The IRS also announced that the due date for requests for approval of a magnetic medium and for waiver requests would be extended from 6/30/86 to 7/31/86 for Forms W-2 and W-2P to be filed in 1987. Applications for approval of a magnetic medium for the filing of Forms W-2 and W-2P must be filed with the Social Security Administration, P.O. Box 2317, Baltimore, MD 21203, Attn: Magnetic Media Group. Requests for hardship waivers must be submitted to the IRS on Form 8508, Request for Waiver From Filing Information Returns on Magnetic Media, or in a letter containing all the necessary information. The request should be sent to Magnetic Media Reporting, IRS National Computer Center, P.O. Box 1359, Martinsburg, WV 25401-1359. Revenue Procedure 86-31 will appear in Internal Revenue Bulletin No. 1986-26, dated 6/30/86. For further information contact the IRS at 202/566-4024.

**SPECIAL: GOVERNMENT AUDITING CONFERENCE SCHEDULED BY AICPA**

The AICPA's annual Governmental Accounting and Auditing Update Conference will be held 8/25-26/86 in Washington, D.C. at the Hyatt Regency Hotel on Capitol Hill. Topics to be addressed at the conference include guidance and advice about the Single Audit Act of 1984, how to improve the quality of governmental audits, current developments in governmental accounting and auditing, the impact of the balanced budget act (Gramm-Rudman-Hollings Act) on governmental units, and other current issues of interest to grantors, recipients, government executives, and independent auditors. Comptroller General of the U.S. Charles A. Bowsher will deliver the keynote address. Also addressing the conference will be U.S. Rep. Frank Horton (R-NY), the Ranking Minority Member of the House Government Operations Committee, which has conducted hearings regarding the quality of audits performed by nonfederal auditors. A proposal by the AICPA about how to improve the quality of audits will also be a topic of discussion at the conference. Recommended CPE credit is 16 hours. For further information contact the AICPA Meetings Department at 212/575-6451.

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